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Item 6 of the Agenda

EPSAS issue paper on the accounting treatment of loans and borrowings

*Paper by PwC on behalf of Eurostat
- for discussion*



Accounting treatment of loans and borrowings with a view to financial reporting requirements under the future European Public Sector Reporting Standards (EPSAS)

September 2018

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1 Objectives of the issue paper

The aim of this issue paper is to summarise the approaches taken at the accounting standard level concerning the most important types of loans and borrowings in at least three Member States with high accounting maturity. It addresses the approaches which are being used under the existing international financial reporting frameworks (IPSAS, EU AR, IFRS and ESA 2010, including where relevant and applicable the Manual on Government Deficit and Debt), or are likely to be developed.

Based on the request from Eurostat, the issue paper addresses the following questions:

- What are the most important categories of loans and borrowings, and for which may problematic points/ issues with regards to definition, recognition, measurement and presentation arise?
- Which accounting guidance is available for loans and borrowings in IPSAS, EU Accounting Rules, national accounting standards in three EU MSs, IFRS and ESA 2010 and, where relevant and applicable, also MGDD?
- How do the analysed approaches in the three MSs differ from the treatment under IPSAS (please list the main elements/ aspects)?
- For the main categories of loans and borrowings, what are the advantages and disadvantages of the existing approaches to recognition and measurement under the existing standards (IPSAS, EU AR, national accounting standards in EU MSs, IFRS and ESA 2010 and, where relevant and applicable, also MGDD)?
- What are the main difficulties/ issues when accounting for the main categories of loans and borrowings?
- If/ how a European harmonisation could be achieved in accounting for the main categories of loans and borrowings?
- Taking into account costs and benefits, what way forward in practice would PwC recommend for EPSAS on loans and borrowings?
- What were the consequences of the recommended way forward for a possible convergence between IPSAS / EPSAS and ESA 2010 (and if relevant and applicable, also MGDD)?

Based on the analysis performed, an approach for organising the future discussion on loans and borrowings with the EPSAS stakeholders is proposed.

2 Background of the issue

Governments at all levels often incur large amounts of borrowings to fund their activities, including their social programs or the construction of infrastructure assets. These represent a very significant portion of liabilities in the balance sheet.

They may also provide loans as financial support to government entities or to other categories of economic operators, including in times of financial distress. The financial crisis has led some governments to intervene in various ways, including by taking an investment in financial institutions that needed a capital injection or by purchasing 'toxic' financial assets. Sometimes, governments can provide loans at below market conditions (concessionary loans).

The Staff Working Document accompanying the report from the Commission to the Council and the European Parliament COM(2013) assessing the suitability of IPSAS for the EU Member States, in Annex 7.1, points out that IPSAS 28 to 30 (Financial instruments: presentation, recognition, measurement and disclosures) are the "*standards that are seen as needing to be amended for implementation*". More specifically, the document mentions in Annex 6.1 "*These standards are seen as not sufficiently adapted to public sector characteristics. In particular, the classification of financial assets required by this standard is seen as not suitable for some countries. The standard is seen as problematic for some countries that currently use a nominal value basis, whereas the standard calls for measurement after initial recognition at amortised cost using the effective interest method for loans and receivables and held-to-maturity investments. Accounting for financial instruments on a fair value basis on initial recognition is also considered complex because entities need to apply judgment in determining the market value of similar instruments with the same term, currency and risk profile, on the transaction date*".¹

The report commissioned by Eurostat and prepared by PwC in 2014 reads on loans and borrowings "*About half of the EU central governments account for borrowings (15) and loans (14) using the amortised cost method. The amortised cost method is the measurement method prescribed by IPSAS for loans and borrowings. It uses the effective interest rate, which is the rate that exactly discounts future cash payments or receipts through the expected life of the financial asset or liability*".²

The report also says "*Accounting for financial instruments should be adapted to the characteristics of the public sector /.../ Specific guidance is also provided in IPSAS 29 on concessionary loans that are common in the public sector*".³

Further, the PwC report of 2014 classifies IPSAS 29 'Financial instruments: recognition and measurement' and IPSAS 30 'Financial instruments: disclosures' in the category of standards that (may) need (some) amendments or for which implementation guidance is (may be) needed. This classification is proposed in the light of the analyses of the comments expressed by the Member

¹ See Commission Staff Working Document (SWD) 2013 accompanying the report from the Commission to the Council and the European Parliament COM(2013) 114 assessing the suitability of IPSAS for the EU Member States, Brussels, 6 March 2013, p.115.

² See PwC, Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards, 2013/S 107-182395, 1 August 2014, p.112.

³ See PwC, Collection of information [...], 1 August 2014, p. 132.

States on the IPSAS standards (chapter 8, section 8.1) and identification of the stakeholders' needs in terms of government accounting and reporting (chapter 8, section 8.2).

More specifically, the report concludes re IPSAS 29 'Financial instruments: recognition and measurement': *Concerns relating to this standard are mostly expressed in general terms, including the appropriateness to apply fair value measurement for public sector entities. While we do not believe that there is an urgent need to change much in the standard, except as part of the normal maintenance plan of the standards (and the need to follow up the latest developments in IFRS), it is probably sound to confirm the basic principles and objectives underlying financial instruments accounting. This mainly concerns the need to reflect in a transparent way in the financial statements the substance of the (sometimes complex) financing arrangements, the financial risks that are taken by governments when they enter into significant and risky transactions, including financial guarantees, use of derivatives, investments in financial institutions or other private entities. Governments at all levels also often incur large amounts of borrowings to fund their activities, including their social programs or the construction of infrastructure assets. These transactions should be properly reflected in the financial statements. It should finally be reminded that the IPSASB plans to publish a standard dealing with financial instruments issues that are specific to the public sector in 2016.*"

The conclusion is the following regarding IPSAS 30 'Financial instruments: disclosures': *"Some Member States express the view that the detailed disclosure requirements of IPSAS 30 go beyond the needs of public sector companies. Keeping in mind that transactions that expose governments to significant financial risks should be properly disclosed, it might be envisaged to review (some of) the disclosure requirements of IPSAS 30 in view of the European needs and/or to provide additional guidance on how to apply these. IPSAS 28 'Financial instruments: presentation' is not addressed by the comments made by Member States but it will be necessary to keep in mind that requirements included in this standard may potentially be impacted by the discussions on IPSAS 29 and IPSAS 30. IPSAS 28 is classified under category 3 'Standards that might be implemented with minor or no adaptation'."*⁴

The report of the cell on FTI proposes the hierarchy for initial measurement for financial assets and liabilities, other than complex financial instruments.⁵

⁴ See PwC, Collection of information [...], 1 August 2014, pp. 134 and 138.

⁵ See Eurostat, Guidance for the first time implementation of accrual accounting, April 2017, 34 pages - <https://circabc.europa.eu/d/a/workspace/SpacesStore/d1b2b587-c4b8-4fdf-a2e2-5735ae362b15/First%20time%20implementation%20guidance.pdf>

3 Description of accounting guidance available in international accounting frameworks and in statistical rules

Accounting guidance available is discussed below, successively for the following accounting and reporting frameworks: IPSAS, EU Accounting Rules, IFRS and ESA 2010 (including references to the MGDD).

IPSAS rules are explained more in-depth, because IPSAS has been viewed as a reference framework for the future EPSAS, EU Accounting Rules are based on them and IFRS rules are similar in many respects.

3.1 International Public Sector Accounting Standards (IPSAS)

3.1.1 Applicable standards

Accounting rules relating to financial instruments can be found in IPSAS 28 ‘Financial instruments: Presentation’, IPSAS 29 ‘Financial instruments: Recognition and Measurement’, and IPSAS 30 ‘Financial instruments: Disclosures’.

The presentation requirements for financial instruments are established in IPSAS 28. They address the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends or similar distributions, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

IPSAS 30 addresses disclosure requirements that will enable the users to evaluate the significance of financial instruments for the entity’s financial position and performance and the nature and extent of risks arising from financial instruments and how the entity manages those risks.

At its 2018 June meeting, the IPSASB approved a draft of IPSAS 41 ‘Financial instruments’ and decided to proceed with the new standard with no substantial change to ED 62 ‘Financial instruments’. IPSAS 41 is largely based on its IFRS equivalent, IFRS 9 ‘Financial instruments’ and replaces IPSAS 29. The new standard will be effective on 1 January 2022, with earlier application permitted.

The new standard brings significant improvements to the existing recognition and measurement rules relating to financial instruments in three main areas:

- a new single classification and measurement model for financial assets that considers the characteristics of the asset’s cash flows and the objective for which the asset is held;
- a single forward-looking impairment model, the expected credit loss (ECL) model, that is applicable to all financial instruments subject to impairment testing;
- an improved hedge accounting model that broadens the hedging relationships in scope of the guidance. The model develops a strong link between an entity’s risk management strategies and the accounting treatment for instruments held as part of the risk management strategy.

The first two areas of improvement are applicable to loans and borrowings and will be dealt with in the present issue paper.

In addition, IPSAS 41 also includes specific guidance and illustrative examples to properly address the public sector context.

Given these latest developments, we only briefly address the requirements of IPSAS 29 in the following pages but instead explain in more detail the new recognition and measurement rules of IPSAS 41 applicable to loans and borrowings.

Finally, IPSAS 33 'First-time adoption of accrual basis IPSAS' allows some relaxation in accounting for financial instruments by public sector that apply IPSAS for the first time.

3.1.2 Scope and definition of loans and borrowings

Under IPSAS 28.9, a financial asset is any asset that is:

- (a) Cash;
- (b) An equity instrument of another entity;
- (c) A contractual right:
 - (i) To receive cash or another financial asset from another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) A contract that will or may be settled in the entity's own equity instruments and is:
 - (i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

A financial liability is any liability that is:

- (e) A contractual obligation:
 - (i) To deliver cash or another asset financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (f) A contract that will or may be settled in the entity's own equity instruments and is:
 - (i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Loans are non-derivative financial assets that are debt instruments and borrowings are non-derivative financial liabilities.

Loans and borrowings are those instruments that are analysed in the present issue paper.

3.1.3 Recognition of an asset and liability

An entity should recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument (IPSAS 41.10).

A regular way purchase or sale of financial assets is recognized using either trade date accounting or settlement date accounting (IPSAS 41.AG17).

3.1.4 Measurement

3.1.4.1 Initial measurement

A financial asset or financial liability is initially recognised and measured at its fair value⁶ plus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (IPSAS 41.57).

3.1.4.2 Subsequent measurement - Financial assets

Existing IPSAS 29

IPSAS 29 prescribes a rules-based approach to classification of financial assets. The requirements are summarised in the following table.

Figure 1: Overview of the classification and measurement requirements for financial assets under the old IPSAS 29

Categories of financial assets	Description, examples	Measurement
At fair value through profit or loss (FVTPL)	Derivatives or designated at inception	Fair value (FV) with changes in FV through P/L
Loans and receivables	Fixed or determinable amounts	Amortised cost
Held to maturity (HTM) debt instruments	If intention and ability to hold to maturity (e.g. bonds)	Amortised cost
Available for sale (AFS) debt instruments	Residual category	Fair value with changes in FV in equity. Impact P/L upon impairment or sale

⁶ This does not apply to short-term receivables and payables if the effect of discounting is immaterial.

New IPSAS 41

In contrast, the recently published IPSAS 41 prescribes a new classification model for financial assets that are debt instruments based on both the contractual cash flow characteristics of the instrument and the entity's management model for financial assets. The analysis of these contractual cash flow characteristics and business model determines whether the financial asset is measured either at amortised cost, fair value through net assets/equity or fair value through surplus or deficit (IPSAS 41.39).

A financial asset shall be measured at amortised cost if both of the following conditions are met:

- (a) The financial asset is held within a management model whose objective is to hold financial assets in order to collect contractual cash flows; and
- (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal⁷ and interest⁸ (SPPI) on the principal amount outstanding.

Paragraphs AG48-AG88 provide guidance on how to apply these conditions (IPSAS 41.40).

A financial asset shall be measured at fair value through net assets/equity if both of the following conditions are met:

- (a) The financial asset is held within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs AG48-AG88 provide guidance on how to apply these conditions too (IPSAS 41.41).

Financial assets that are debt instruments and that do not fall in one of the above two categories are measured at fair value through surplus or deficit (IPSAS 41.43).

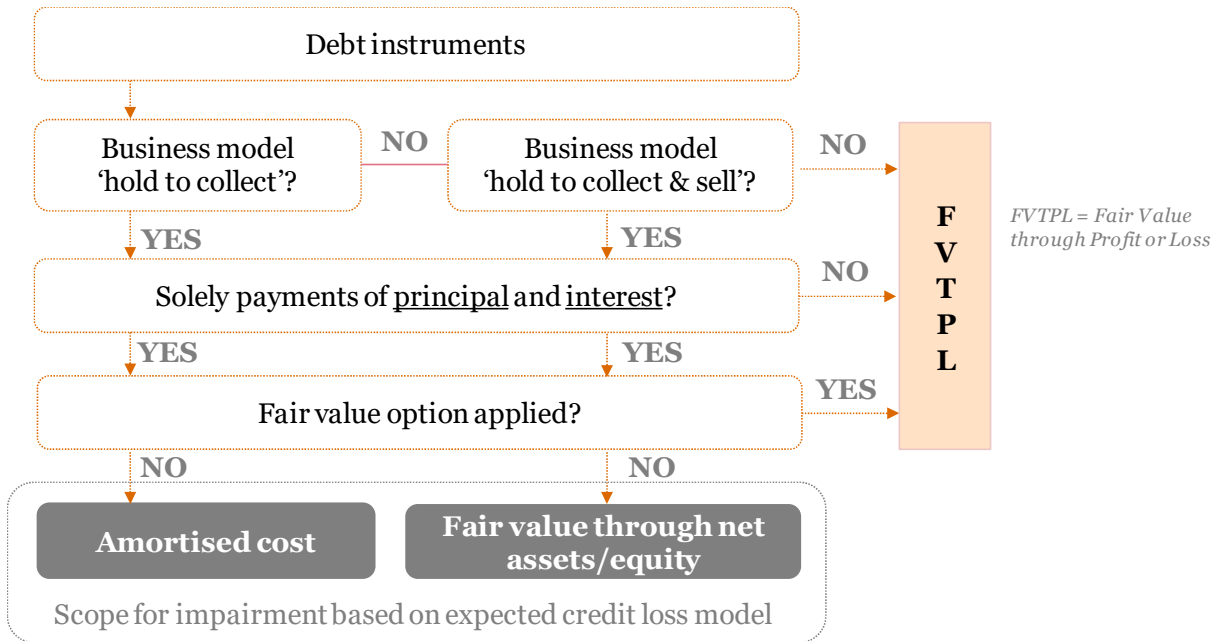
In addition, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through surplus or deficit if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (IPSAS 41.44).

The new classification and measurement requirements applicable to financial assets that are debt instruments are summarised in the table on the following page.

⁷ Principal is the fair value of the financial asset at initial recognition. Paragraph AG64 provides additional guidance on the meaning of principal.

⁸ Interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. Paragraphs AG63 and AG67-AG71 provide additional guidance on the meaning of interest, including the meaning of the time value of money.

Figure 2: Overview of the classification and measurement requirements for financial assets under the new IPSAS 41



Amortised cost and fair value are two important concepts under the rules applicable to financial instruments. They are explained in more detail below.

Amortised cost

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance (IPSAS 41.9).

Figure 3: Formula to calculate amortised cost

$$\text{Amortised cost} = \text{Cash paid} - \text{Principal repayments} +/\text{- Unamortised premiums or discounts} - \text{Impairment}$$

The effective interest method is the method that is used in the calculation of the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and in the allocation of the interest revenue or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments) (IPSAS 41.9).

The effective interest rate is the interest prevailing at the inception of the loan and does not change subsequently.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument (IPSAS 41.9).

Illustrative example:

The following example illustrates the calculation of the amortised cost of a borrowing. A borrowing is a financial liability but the methodology for the calculation applies mutatis mutandis to a financial asset. The fact pattern is the following:

- Bond issued with a face value of EUR 100,000 bearing interest at 10% and redeemable in 5 years.
- Issued with a 3% discount.
- Transactions costs of 2,000.

Figure 4: Calculation of the amortised cost of a borrowing

Effective interest rate	11.37%			
Number of years	Carrying amount at 1/1/N	Interest expense	Cash flow	Carrying amount at 31/12/N
0	-		95,000	95,000
1	95,000	10,797	(10,000)	95,797
2	95,797	10,888	(10,000)	96,685
3	96,685	10,988	(10,000)	97,673
4	97,673	11,101	(10,000)	98,774
5	98,774	11,226	(110,000)	-

Fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

IPSAS 41 takes over the guidance in IPSAS 29 which establishes a fair value hierarchy. In determining fair value, an entity should consider:

- firstly, quoted prices in an active market (level 1); and
- then valuation techniques (market comparables, discounted cash flows) making maximum use of market inputs (level 2 if inputs are based on market data, level 3 if not).

The fair value of a financial instrument at initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also paragraph AG117). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique. For example, the fair value of a long-term loan that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating (IPSAS 41.AG115).

Any additional amount lent is an expense or a reduction of revenue unless it qualifies for recognition as some other type of asset. AG116. If an entity originates a loan that bears an off-market interest rate (e.g. 5% when the market rate for similar loans is 8%), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives (IPSAS 41.AG116).

The best evidence of fair value is the transaction price unless fair value is based on market comparables or on a valuation technique whose variables only include data from observable markets (IPSAS 41.AG117).

3.1.4.3 Concessionary loans

Concessionary loans are loans granted to or received by an entity at below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education and housing loans granted to low income families. Entities may receive concessionary loans, for example, from development agencies and other government entities (IPSAS 41.AG118).

As concessionary loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. At initial recognition, an entity therefore analyses the substance of the loan granted or received into its component parts, and accounts for those components using the principles as listed further below.

An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a non-exchange transaction, a contribution from owners or a combination thereof. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. An entity determines the fair value of the loan by using the quoted prices on an active marker, or it uses a valuation technique

in case there is no active market for such a loan. Fair value using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan (IPSAS 41.AG124).

Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:

- a) Where the loan is received by an entity, the difference is accounted for in accordance with IPSAS 23, "Revenue from non-exchange transactions".
- b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition, except where the loan is a transaction with owners, in their capacity as owners. Where the loan is a transaction with owners in their capacity as owners, for example, where a controlling entity provides a concessionary loan to a controlled entity, the difference may represent a capital contribution, i.e., an investment in an entity, rather than an expense (IPSAS 41.AG125).

Booking entries in respect of concessionary loans are as follows:

At inception

Dr Loan (at fair value - NPV using the prevailing market interest rate)
Dr Financial expense (day one loss)
To Cr Cash

Over the period of the loan

Dr Loan (gradually reconstitute nominal amount at maturity date)
To Cr Financial income (unwinding of the discount - financial income reflecting normal market conditions)

A concessionary loan is different from a waiver of debt and an originated credit-impaired loan.

The granting or receiving of a concessionary loan is distinguished from the waiver of debt owing to or by an entity. For example, a government may lend money to a not-for-profit entity with the intention that the loan be repaid in full on market terms. However, the government may subsequently write-off part of the loan. This is not a concessionary loan as the intention of the loan at the outset was to provide credit to an entity at market related rates (IPSAS 41.AG119-120).

An originated credit-impaired loan does not include any non-exchange component; it is a loan where one or more events, that have a detrimental impact on the estimated future cash flows of the financial asset, have occurred. The lender expects a portion of the contractual cash flows to be uncollectible but has not given up any hope to collect them; it can collect more cash flows than originally estimated. In a concessionary loan, the concessionary element is given up. The difference between the transaction price and the fair value of an originated credit-impaired loan is recognised as a credit loss in the statement of financial performance (rather than as a concession) (IPSAS 41.AG121-122 and IG.G5).

3.1.4.4 Loan commitments

Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit are within the scope of IPSAS 41 (IPSAS 41.4). For undrawn loan commitments, the credit loss to be recognised is the present value of the difference between: (a) the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan; and (b) the cash flows that the entity expects to receive if the loan is drawn down (IPSAS 41.AG194). Any loss allowance in respect of loans commitments is recognised against a loan commitment liability (IPSAS 41.AG8E).

Other loan commitments that the entity does not designate as financial liabilities at fair value through surplus or deficit, are initially measured at fair value and subsequently at the higher of:

- (a) The amount of the loss allowance determined in accordance with the expected credit loss model in IPSAS 41; and
- (b) The amount initially recognised less the cumulative amount of amortisation recognised in accordance with the standard on revenue from exchange transactions (currently IPSAS 9).

The treatment of loan commitments is thus similar to the one of financial guarantees.

3.1.4.5 Impairment

Existing incurred credit loss model under IPSAS 29

An entity should carry out an impairment test (incurred credit loss model) if there is an objective evidence of impairment (e.g. a decline in the expected cash flows generated by the asset).

An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant, as per paragraph 68 of IPSAS 29. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment. Any impairment that is no longer justified in a subsequent period is reversed.

- *Financial assets measured at amortised cost*

The impairment loss is the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate. The carrying amount of the asset is reduced either directly or through use of an allowance account. The amount of the loss is recognised in surplus or deficit.

- *Financial assets measured at fair value*

When an impairment is identified, the cumulative unrealised loss resulting from changes in fair value that had been recognised directly in equity should be removed from equity and recognised in profit and loss for the period.

The impairment loss is difference between the acquisition cost (net of any principal amount and amortisation) and the current fair value, i.e. the recoverable amount calculated as the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.

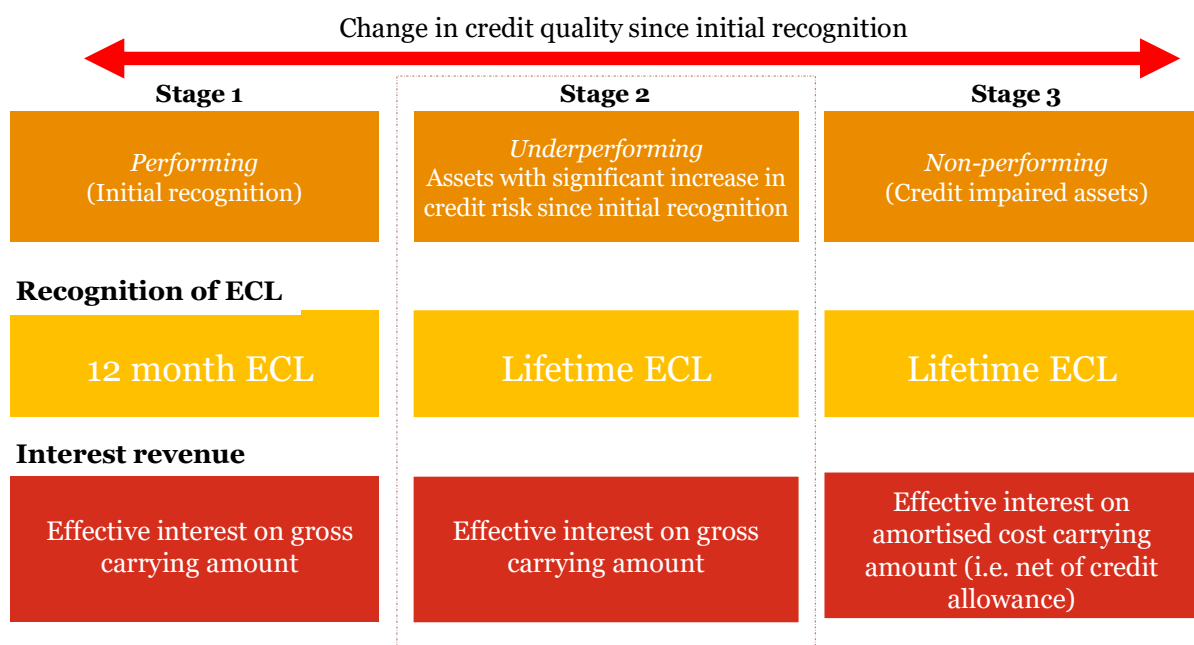
New expected credit loss model under IPSAS 41

IPSAS 41 requires impairment testing on financial assets to be carried out in accordance with the new single forward-looking expected credit loss model, which builds on IFRS 9.

The forward-looking model requires an entity to recognise expected credit losses at all times and will result in earlier recognition of losses. The model uses a dual measurement approach whereby expected credit losses are measured as either 12-month expected credit losses or lifetime expected credit losses.

The new standard outlines a ‘three-stage’ model (‘general model’) for impairment based on changes in credit quality since initial recognition (see Figure 5 below).

Figure 5: Overview of the expected credit loss model under IPSAS 41



Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month expected credit losses (‘ECL’) are recognised and interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance). 12-month ECL are the expected credit losses that result from default events that are possible within 12 months after the reporting

date. It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months.

Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognised, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL are the expected credit losses that result from all possible default events over the expected life of the financial instrument. Expected credit losses are the weighted average credit losses with the probability of default ('PD') as the weight.

Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

IPSAS 41 requires management, when determining whether the credit risk on a financial instrument has increased significantly, to consider reasonable and supporting information available, in order to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial instrument.

PwC observation

The ECL model relies on a relative assessment of credit risk. This means that a loan with the same characteristics could be included in Stage 1 for one entity and in Stage 2 for another, depending on the credit risk at initial recognition of the loan for each entity.

Moreover, an entity could have different loans with the same counterparty that are included in different stages of the model, depending on the credit risk that each loan had at origination.

Subsequent measurement - Financial liabilities

The requirements relating to the subsequent measurement of financial liabilities included in IPSAS 29 are carried forward unchanged in IPSAS 41 and are summarised below.

Figure 6: Overview of the classification and measurement requirements for financial liabilities

Categories of financial liabilities	Description, examples	Measurement
At fair value through profit or loss (FVTPL)	Derivatives or designated at inception	Fair value with changes in FV through P/L
Other financial liabilities	Not entered into for trading purposes	Amortised cost

3.1.5.2 Financial liabilities

Financial liabilities are derecognised when they are extinguished under the following circumstances:

- The obligation is discharged (e.g. settled through payment), waived, cancelled or expires.
- The obligation is assumed by a third party; or
- The terms and conditions of the arrangement are substantially modified (IPSAS 41.35-36).

A substantial modification in terms occurs when the discounted present value of the cash flows including fees, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability (IPSAS 41.AG46).

The magnitude of the change depends on the specific terms of the restructuring. If the modification is substantially different, the original debt is derecognised as it is deemed to be extinguished, and any costs or fees incurred are recognised as part of the gain or loss on that extinguishment. Following derecognition of the original liability, a new financial liability is recognised.

If a modification is not considered substantial, there is not an extinguishment and the original financial liability is not derecognised. There will, however, be a change in the carrying amount of the financial liability, based the modified future cash flows. Any costs or fees incurred adjust the carrying amount and are amortised over the remaining term of the modified financial liability.

Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies IPSAS 23 (IPSAS 41.37).

IPSAS staff has issued a Q&A paper dealing with the accounting treatment of sovereign debt restructurings under IPSAS⁹.

3.1.6 *Presentation and disclosures*

The objective of IPSAS 30 is to require entities to provide disclosures that enable users to evaluate the significance of financial instruments for the entity's financial position and performance, and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

These general objectives are also applicable to disclosures relating to loans and borrowings.

An entity reporting under IPSAS should disclose specific information as defined in the standard IPSAS 30. Key disclosures in respect of loans and borrowings include:

- classes of financial instruments;
- significance of financial instruments for financial position and financial performance;
- fair value and fair value hierarchy: information on level 1, level 2 and level 3 fair values;
- nature and extent of risks arising from financial instruments.

⁹ IPSAS, Staff questions and answers, Accounting for sovereign debt restructurings under IPSAS, May 2015, 5 pages

Qualitative as well as quantitative information should be given on credit risk (including on credit quality of financial assets, on any concentration of credit risk, and on the impact of collaterals obtained), liquidity risk and market risk (including a sensitivity analysis on potential movements in exchange rates, interest rates, etc.).

3.1.7 First-time adoption of accrual basis IPSAS

The standard IPSAS 33 'First-time adoption of accrual basis IPSAS' provides a number of transitional measures in order to facilitate the transition towards accruals accounting. In respect of financial instruments, a number of exemptions are provided during a relief period of three years:

- Should a first-time adopter not have recognised certain financial instruments under its previous basis of accounting, it is not required to recognise or measure these for reporting periods beginning on a date within three years following the date of adoption of IPSASs. Application of this exemption however affects the fair presentation and compliance with accrual basis IPSASs during the period of adoption. This means that the entity cannot claim IPSAS compliance as long as it does not fully comply, in all material respects, with IPSAS.
- A first-time adopter may elect to measure the identified financial instruments in the opening balance at fair value as deemed cost. This 'fair value as deemed cost' exemption does not affect fair presentation and compliance with accrual basis IPSASs during the period of adoption.

3.2 European Union Accounting Rules (EAR)

European Union Accounting Rules constitute the accounting framework of the European Union institutions, including the European Commission (EC) and its agencies. EAR 11 'Financial instruments' retains the definitions and concepts of IPSAS 28, 29 and 30 as regards the scope, recognition, measurement and disclosures of financial instruments. No alignment has been made with IPSAS 41 yet as this standard was just issued by the IPSASB.

As the IPSAS principles have already been explained under Section 3.1 International Public Sector Accounting Standards (IPSAS), they are not repeated here.

However, specific guidance is provided in EAR 11 in respect of 'financial support loans without market'.

Financial support loans granted by EU entities from borrowed funds are measured at nominal value since these are not concessionary loans. Rather, these are loans granted with the sole purpose of providing financial support to the beneficiary - thus there is an absence of an active comparable market. The EU only borrows money to provide this assistance and therefore it does not seek out alternate investment opportunities for borrowed monies. There is thus no basis of comparison with market rates. Examples of such financial support facilities include the European Financial Stabilisation Mechanism and Balance of Payments loans.

The transaction price is considered to be at fair value at day 1 of the transaction. This is because the best evidence of the fair value of a financial instrument at initial recognition, in an exchange transaction, is the transaction price (i.e. the fair value of the consideration given or received) unless

the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. The nominal interest rate thus is considered the effective interest rate reflecting the fact that there is no active market or similar transactions to compare with.

3.3 International Financial Reporting Standards (IFRS)

Currently, IFRS rules on accounting for loans and borrowings is included in the following standards:

- IAS 32 ‘Financial instruments: presentation’;
- IFRS 9 ‘Financial instruments’ which replaces IAS 39 ‘Financial instruments: recognition and measurement’ and is applicable from 1 January 2018; and
- IFRS 7 ‘Financial instruments: disclosures’.

IAS 32 focuses on establishing principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

IFRS 9 addresses the principles of recognition, measurement and de-recognition of financial assets and liabilities. Key issues are selection of measurement basis (amortised cost or fair value), impairment of financial assets, recognition of interest income, accounting for embedded derivatives and hedge accounting.

IFRS 7 addresses disclosure requirements that will enable users of its financial statements to evaluate the significance of financial instruments for its financial position and performance, as well as the nature and extent of risks arising from financial instruments and how the entity risk management practices.

As IPSAS rules relating to financial instruments are aligned on IFRS, especially since the issuance of IPSAS 41, which aligns on IFRS 9, IFRS rules are not analysed further here.

3.4 ESA 2010

3.4.1 Scope and definition

3.4.1.1 General

Chapter 5 of the ESA 2010 manual deals with financial transactions. Financial transactions (F) are transactions in financial assets (AF) and liabilities between resident institutional units, and between them and non-resident institutional units (ESA 2010 5.01). A financial transaction between institutional units is a simultaneous creation or liquidation of a financial asset and the counterpart liability, or a change in ownership of a financial asset, or an assumption of a liability (ESA 2010 5.02).

Financial assets are stores of value representing a benefit or series of benefits accruing to the economic owner through holding or using the assets over a period of time. They are a means of carrying forward value from one accounting period to another. Benefits are settled through payments (ESA 2010 5.04).

A financial claim is the right of a creditor to receive a payment or series of payments from a debtor. Financial claims are financial assets that have corresponding liabilities (ESA 2010 5.05). Maintaining symmetry in the macroeconomic statistical system is a fundamental principle. Liabilities are established when a debtor is obliged to provide a payment or a series of payments to a creditor (ESA 2010 5.06).

Loans and debt securities are financial assets.

3.4.1.2 Loans

Loans are one of the different categories of financial assets (coding AF.4). Loans are created when creditors lend funds to debtors (ESA 2010 5.112). Loans are characterised by the following features:

- (a) the conditions governing a loan are either fixed by the financial corporation granting the loan or agreed by the lender and the borrower directly or through a broker;
- (b) the initiative to take out a loan normally lies with the borrower; and
- (c) a loan is an unconditional debt to the creditor which has to be repaid at maturity and which is interest-bearing (ESA 2010 5.113).

Loans can be financial assets or liabilities of all resident sectors and the rest of the world. Deposit taking corporations normally record short-term liabilities as deposits, not as loans (ESA 2010 5.114).

3.4.1.3 Debt securities

Debt securities (AF.3) are negotiable financial instruments serving as evidence of debt (ESA 2010 5.89). The distinction between transactions in loans (F.4) and transactions in debt securities (F.3) is that loans are non-negotiable financial instruments while debt securities are negotiable financial instruments (ESA 2010 5.120).

Debt securities have the following characteristics:

- (a) an issue date on which the debt security is issued;
- (b) an issue price at which investors buy the debt securities when first issued;
- (c) a redemption date or maturity date on which the final contractually scheduled repayment of the principal is due;
- (d) a redemption price or face value, which is the amount to be paid by the issuer to the holder at maturity;
- (e) an original maturity, which is the period from the issue date until the final contractually scheduled payment;
- (f) a remaining or residual maturity, which is the period from the reference date until the final contractually scheduled payment;
- (g) a coupon rate that the issuer pays to holders of the debt securities; the coupon may be fixed throughout the life of the debt security or vary with inflation, interest rates, or asset prices. Bills and zero-coupon debt securities offer no coupon interest;
- (h) coupon dates, on which the issuer pays the coupon to the securities' holders;
- (i) the issue price, redemption price, and coupon rate may be denominated (or settled) in either national currency or foreign currencies; and
- (j) the credit rating of debt securities, which assesses the credit worthiness of individual debt securities issues (ESA 2010 5.90).

3.4.2 Measurement of loans and borrowings

3.4.2.1 General valuation principles

A face value is the amount to be paid by the issuer to the holder at maturity (ESA 2010 5.90).

Nominal value is not the same as face value. It reflects the sum of funds originally advanced, plus any subsequent advances, less any repayments, plus any accrued interest. Specific cases include the following:

- The nominal value in domestic currency of a financial instrument denominated in foreign currency includes holdings gains or losses arising from movements in exchange rates.
- For financial instruments like debt securities linked to a narrow index, the nominal value can also include holding gains or losses arising from movements in the index (ESA 2010 7.39).

The market value is that at which financial assets are acquired or disposed of, between willing parties, on the basis of commercial considerations only, excluding commissions, fees and taxes. In determining market values, trading parties also take account of accrued interest (ESA 2010 7.38). At any specific point in time, the market value of a financial instrument may deviate from its nominal value due to revaluations arising from market price changes (ESA 2010 7.39).

3.4.2.2 Loans

Loans, as financial assets that are non-negotiable, are valued at nominal value. The values should exclude commissions, fees and taxes. Commissions, fees and taxes are recorded as services provided in carrying out the transactions (ESA 2010 7.61).

The values to be recorded in the balance sheets of both creditors and debtors are the nominal values, irrespective of whether the loans are performing or non-performing (ESA 2010 7.70).

The financial balance sheet shows, on its left side, financial assets and, on its right side, liabilities. The balancing item of the financial balance sheet is financial net worth (BF.90).

The ESA values balance sheet at market value, except for three specific instruments: currency and deposits (AF.2), loans (AF.4) and other accounts receivable/payable (AF.8). For those three instruments, the values recorded in the balance sheets of both creditors and debtors are the amounts of principal that the debtors are contractually obliged to repay to the creditors, even in cases where the loan was traded at a discount or premium, including interest accrued (ESA 2010 20.149).

Concessional loans are recorded at their nominal value just as other loans (ESA 2010 20.242).

During a bailout, governments often buy loans from financial institutions for their nominal value rather than their market value. Even though loans are recorded at nominal prices, the transaction is partitioned by recording a capital transfer and an entry in the revaluation accounts. If there is reliable information that some loans are irrecoverable, fully or for nearly their total amount, or if there is no reliable information on the expected loss, these loans are accounted for at zero value and a capital transfer is recorded for their former nominal value (ESA 2010 20.247).

Non-performing loans

Loans, including nonperforming loans, are recorded in the balance sheet at nominal value (ESA 2010 7.99).

In order to show items of more specialised analytic interest for particular sectors, three types of memorandum items are included as supporting items to the balance sheets, and among them: non-performing loans (AF.m2) (ESA 2010 7.94).

A loan is non-performing when:

- (a) payments of interest or principal are 90 days or more past their due date;
- (b) interest payable of 90 days or more has been capitalised, refinanced, or delayed by agreement; or
- (c) payments are less than 90 days overdue, but there are other good reasons (such as a debtor filing for bankruptcy) to doubt that payments will be made in full (ESA 2010 7.101).

This definition of a non-performing loan is to be interpreted taking into account national conventions on when a loan is deemed to be non-performing. Once a loan is classified as non-performing, it (or any replacement loans) should remain classified as such until payments are received or the principal is written off on this or subsequent loans that replace the original (ESA 2010 7.102).

Two memorandum items are foreseen for nonperforming loans:

- (a) the nominal value of such loans, as recorded in the main balance sheet; and
- (b) the market equivalent value of such loans (ESA 2010 7.103).

Disclosure of memorandum items for nonperforming loans is not mandatory.

The closest approximation to market equivalent value is fair value, which is 'the value that approximates to the value that would arise from a market transaction between two parties'. Fair value can be established using transactions in comparable instruments, or using the discounted present value of cash flows; which may be available from the balance sheet of the creditor. In the absence of fair value data, the memorandum item will have to use a second-best approach and show nominal value less expected loan losses (ESA 2010 7.104).

The assessments on loan loss provisions have to be made in the framework of the accounting standards, the legal status and the taxation rules applicable to the units, which might lead to rather heterogeneous results in terms of amounts and duration of loan loss provisions. This makes it difficult to record non-performing loans in the main accounts and leads to their recording as a memorandum item. It is preferable instead to provide market equivalent values as memorandum items in addition to the nominal values of loans, performing and non-performing (ESA 2010 7.108).

3.4.2.3 Debt securities

Debt securities, as negotiable financial instruments, are valued at market value (ESA 2010 7.67). The values should exclude commissions, fees and taxes. As for loans, commissions, fees and taxes are recorded as services provided in carrying out the transactions (ESA 2010 7.61).

Short-term debt securities (AF.31) are valued at market value. If market values are not available, then, provided there are no conditions of high inflation or high nominal interest rates, the market value can be approximated by the nominal value for:

- (a) Short-term debt securities issued at par; and
- (b) Short-term discounted debt securities (ESA 2010 7.68).

Long-term debt securities (AF.32) are valued at market value, whether they are bonds on which interest is paid regularly or deep-discounted or zero-coupon bonds on which little or no interest is paid (ESA 2010 7.69).

Zero-coupon bonds are instruments where the debtor has no obligation to make any payments to the creditor until the redemption of the bond. The amount of the principal borrowed is lower than the value of the bond that will be repaid by the debtor. The difference between the amount repaid at the end of the contract and the amount initially borrowed is interest and is allocated over the accounting periods between the beginning and the end of the contract. The interest accruing each period is treated as if paid by the debtor and then reinvested as an additional amount of the same liability. Interest expenditure and increases in the liability are then simultaneously recorded each period (ESA 2010 20.184).

3.4.3 Presentation

Loans can be categorised into original maturity (short term AF.31 versus long term AF32), currency (national versus foreign currency) and purpose of lending (ESA 2010 5.115-116).

Debt securities include financial assets and liabilities that may be described according to different classifications: by maturity (short term AF.41 versus long term AF.42), holding and issuing sector and subsector, currency (national versus foreign currency), and type of interest rate (variable, fixed or mixed) (ESA 2010 5.91 to 5.102).

3.4.4 Manual on government deficit and debt (MGDD)

Part VII of the MGDD provides additional guidance on the debt related transactions.¹⁰

In particular, the following issues are covered in more details: (1) debt assumption and debt cancellation, including write-downs and write-offs and (2) debt restructuring. The MGDD addresses first the background to the issue and then explains the statistical treatment.

Part VIII of the MGDD provides additional guidance on the measurement of general government debt.¹¹ More details on measurement of liabilities in ESA 2010 when compared to measurement for the EDP (Excessive Deficit Procedure) purposes is provided.

There is no definition of government (EDP) debt in ESA 2010. In ESA 2010, the core equivalent concept is total financial liabilities, which involve a wider list of financial instruments than included in government debt.

For the EDP purposes (see Council Regulation (EC) No 479/2009), the nominal value is considered equivalent to the face value of liabilities (also referred to as “value at par”), whereas the valuation in ESA 2010 balance sheets is the market value, when appropriate. ESA 2010 includes a clarification on valuation principles. ESA 2010 7.39 specifies: “nominal valuation reflects the sum of funds originally advanced, plus any subsequent advances, less any repayments, plus any accrued interest. Nominal value is not the same as face value”.

The definition of government debt for EDP purposes is the following: “debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government”. In the Council Regulation (EC) No 479/2009, as amended, the nominal value is considered equivalent to the face value of liabilities (article 1). The face value is equal to the amount, contractually agreed, that the government will have to refund to creditors at maturity. It is also on this amount (the principal) that the interest is calculated.

In national accounts, interest is recorded when accruing and, whether actually paid or not, accrued interest affects the net lending/borrowing (B.9). Under ESA 2010, accruing interest is continuously added to the value of the instrument in the balance sheet. That value is reduced when the interest is paid. Under the EDP provisions, government debt is measured at nominal value, assimilated to the face value as mentioned above, and accrued interest is not recorded under the corresponding debt instrument. The exception is for instruments issued with a discount where the face value included by anticipation the amount of interest to be accrued over the lifetime of the instrument.

¹⁰ See Eurostat, Manual on Government Deficit and Debt, Part VII Debt related transactions and guarantees, pp 369 to 411.

¹¹ See Eurostat, Manual on Government Deficit and Debt, Part VIII Measurement of government debt, pp 415 to 442.

3.5 Comparison between the different accounting frameworks

The table below provides an overview of the main rules relating to loans and borrowings included in the accounting and reporting frameworks analysed. For IPSAS we only consider in the comparison the new rules included in IPSAS 41.

Figure 8: Comparison between the different accounting frameworks

	<i>IPSAS</i>	<i>EAR</i>	<i>IFRS</i>	<i>ESA 2010</i>
<i>Scope and definition</i>	Loans are non-derivative financial assets that are debt instruments and borrowings are non-derivative financial liabilities.	Similar to IPSAS.	Similar to IPSAS.	A financial claim is a right of a creditor to receive a payment or series of payments from a debtor. Loans and debt securities have certain characteristics. Corresponding liabilities are recognised.
<i>Recognition</i>	When the entity becomes a party to the contractual provisions of the instrument.	Similar to IPSAS.	Similar to IPSAS.	When a creditor has a right to receive payment and creditor has the obligation to provide payment (symmetry).
<i>Measurement</i>	<p>Initial measurement at fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.</p> <p>Subsequent measurement at amortised cost or fair value based on the contractual cash flow characteristics of the instrument and the business model of the entity.</p> <p>Impairment testing based a forward-looking expected credit loss model.</p> <p>Specific guidance exists for concessionary loans at below-market conditions.</p>	<p>Measurement rules are still based on the existing IPSAS 29.</p> <p>Specific guidance for financial support loans without market: the transaction price is the fair value.</p>	Similar to IPSAS.	<p>Loans, as non-negotiable financial instruments, are recorded at nominal value. Commissions, fees and taxes are excluded.</p> <p>Debt securities, as negotiable financial instruments, are valued at market value.</p> <p>To keep symmetry between financial assets and financial liabilities, impairments are not recorded but disclosed as memorandum items.</p> <p>Concessionary loans are measured at nominal value, as any other loans.</p>
<i>Presentation</i>	Presented separately on the face of the balance sheet	Similar to IPSAS.	Similar to IPSAS.	Loans and debt securities are two separate classes of financial assets. Corresponding liabilities are recorded.

	<i>IPSAS</i>	<i>EAR</i>	<i>IFRS</i>	<i>ESA 2010</i>
				Loans are categorised into original maturity, currency and purpose of lending. Debt securities are classified by maturity, holding and issuing sector and subsector, currency and type of interest rate.
<i>Disclosures</i>	Summary of accounting policies and details of balance sheet and profit or loss amounts and movements. Information to understand the impact of the transactions on the financial position, financial performance, cash flows and risks of the entity.	Similar to IPSAS.	Similar to IPSAS.	The nominal value and market value of nonperforming loans is disclosed as memorandum items.

3.5.1 *Scope and definition, recognition and measurement*

Scope and definition, recognition

Under the various frameworks, an entity recognises a financial asset or a financial liability in its statement of financial position when the entity becomes a party to the contractual provisions of the instrument.

Measurement

Under both IPSAS and IFRS, loans and borrowings are initially measured at fair value plus transaction costs. Subsequently, financial assets that are debt instruments (loans are included in this category) are classified and measured either at amortised cost or fair value (through either equity or profit or loss) based on the contractual cash flow characteristics of the instrument and the business model of the entity. Impairment losses are recorded following a single forward-looking expected credit loss model.

Borrowings are accounted for at amortised cost.

As IPSAS 41 was just issued, EAR are based on IPSAS 29 rules and have not been aligned on the new IPSAS rules yet.

Under ESA 2010, loans, as non-negotiable financial instruments, are recorded at nominal value. Debt securities, as negotiable financial instruments such as bonds, are valued at market value. Transaction costs (commissions, fees and taxes) are excluded. To keep symmetry between loans financial assets and financial liabilities, the value nonperforming loans is kept at nominal value but both the nominal value and the fair value of such loans are disclosed as memorandum items.

Fundamental differences in the measurement of financial assets therefore arise between international accounting standards such as IPSAS and IFRS on the one hand and ESA 2010 rules on the other hand.

Presentation and disclosures

Disclosures are detailed under international accounting frameworks while disclosure of information under ESA 2010 rules is limited to certain specific information.

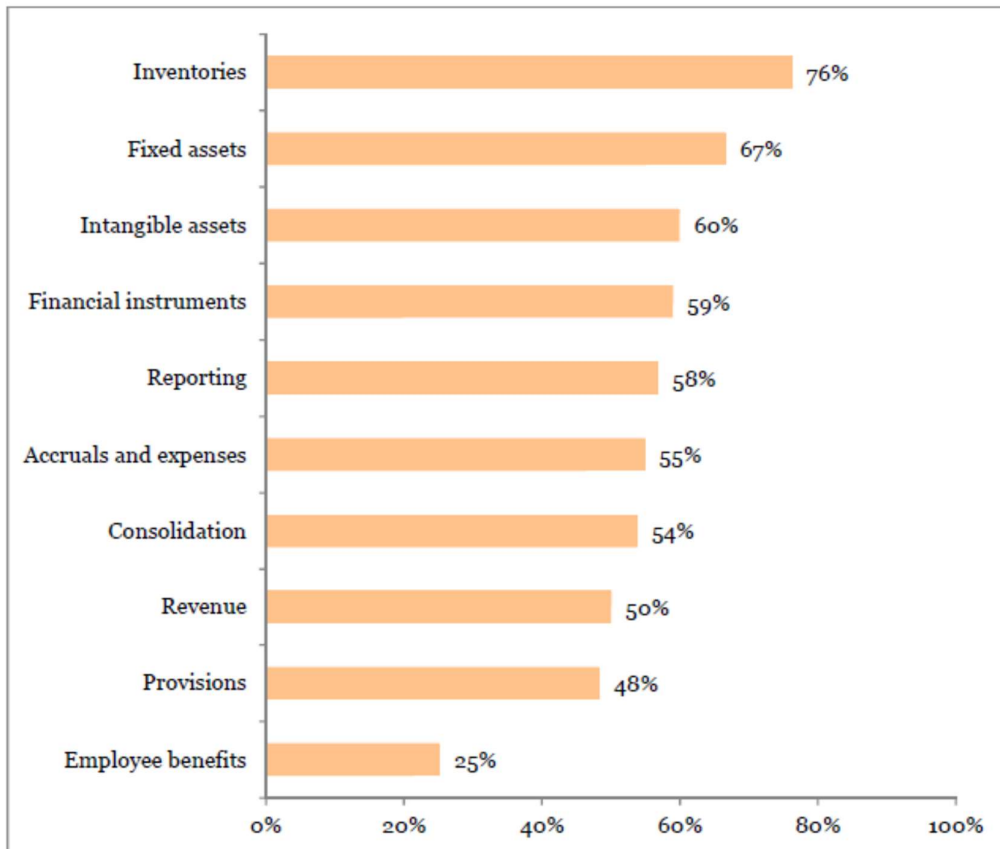
The following important disclosure information is required under ESA 2010 rules: as no impairment is recorded on nonperforming loans, the fair value of such loans is disclosed as memorandum items together with their nominal value.

4 Description of the main types of loans and borrowings in selected EU Member States (France, Lithuania and Sweden)

4.1 Overall accounting maturity for loans and borrowings

Figure 9 below is extracted from the 2014 PwC study. It gives an overview of the average accounting maturity score per accounting area across EU governments and highlights the areas which are more closely aligned with IPSAS requirements across the EU. It indicates an average maturity of 59% for the financial instruments, which puts it at the higher end after the categories 'inventories', 'fixed assets' and 'intangibles'. Loans and borrowings are included in the 'financial instruments' category, which also includes other topics such as financial guarantees and the use of derivatives and hedging.

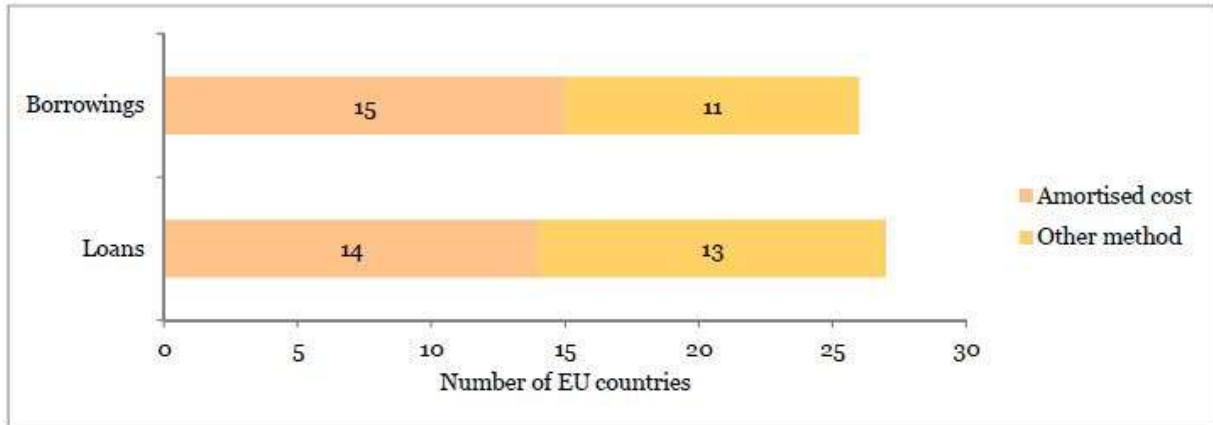
Figure 9: Average accounting maturity per accounting area across the EU¹²



¹² See PwC, Collection of information [...], 1 August 2014, p. 112.

In relation to loans and borrowings, the topics analysed in the questionnaire were the method of accounting for loans and borrowings, assessment of impairment losses, and compliance with IPSAS 28, IPSAS 29 and IPSAS 30. Figure 10 below summarises accounting practices in the 28 EU Member States in respect of loans and borrowings.

Figure 10: Measurement of loans and borrowings¹³



Based on the study, about half of the EU central governments account for borrowings (15) and loans (14) using the amortised cost method. The amortised cost method is the measurement method prescribed by IPSAS for loans and borrowings. It uses the effective interest rate, which is the rate that exactly discounts future cash payments or receipts through the expected life of the financial asset or liability.

The table on the following page presents nonperforming loans in each of the EU Member State in comparison to GDP.

¹³ See PwC, Collection of information [...], 1 August 2014, p. 112.

Figure 11: Non-performing loans in EU Member States, 2016 (% of GDP*)¹⁴

	Non-performing loans (government assets)
Belgium	-
Bulgaria	0.1
Czech Republic	1.4
Denmark	0.3
Germany	0.1
Estonia	0.0
Ireland	0.8
Greece	0.2
Spain	0.2
France	-
Croatia	-
Italy	0.0
Cyprus	-
Latvia	0.2
Lithuania	0.1
Luxembourg	0.0
Hungary	0.0
Malta	0.0
Netherlands	0.0
Austria	1.1
Poland	0.3
Portugal	1.5
Romania	0.0
Slovenia	5.9
Slovakia	0.1
Finland	0.1
Sweden	0.7
United Kingdom	0.0

*GDP figures provided during the October 2017 Excessive Deficit Procedure notification are used for calculation

4.2 Selection of countries

Three different countries with high accounting maturity as per PwC study of 2014 have been selected for a deeper analysis of the accounting treatment used for loans and borrowings: France, Lithuania and Sweden.

¹⁴ Eurostat News Release, 'What is the extent of contingent liabilities and non-performing loans in the EU Member States?', 29 January 2018, p.5

4.3 Methodology

To analyse the approaches taken regarding the accounting treatment of loans and borrowings in the selected Member States, PwC combined an analysis of publicly available information (financial statements, accounting policies) with responses obtained to a questionnaire submitted to government representatives.

The first series of questions addresses the identification of loans and borrowings items and the related recognition criteria. The questionnaire then addresses the measurement of loans and borrowings, including for specific cases such as concessionary loans. The last questions address the challenges experienced upon first-time implementation and in the recurring accounting for loans and borrowings.

A summary of the results of our country-by-country analysis is presented below.

4.4 France

4.4.1 Loans

The carrying amount of loans is EUR 18,958 million at 31 December 2016, which represents 1.9 % only of the total assets of the French central government. They essentially consist of loans to banks and foreign states (EUR 14,739 million). The rest includes other types of loans, including loans that are redeemable under specific conditions. Loans to foreign states include a loan to Greece amounting at EUR 11.4 billion.

As per French state accounting standard 7 'Financial assets', loans and advances are funds paid to third parties under contractual provisions by which the central government undertakes to transfer the use of means of payment to natural and legal persons for a certain period. Commitments under protocols and loan agreements with foreign States, signed but not yet paid or only partially paid, are not included in loans in balance sheet assets but represent commitments given.

Loans and advances are recorded in the period when corresponding rights arise.

Loans and advances are initially measured at nominal repayment value. Subsequent to initial recognition, the carrying amount of loans and advances is equal to their current value, which is an estimated amount assessed with regard to the utility of the receivable for the central government. An impairment loss is recognised when a probable loss arises, meaning when the carrying amount is lower than the nominal repayment amount. The carrying amount of loans to foreign states reflects both the default risk of the counterparty and any impairment loss tied to the loan subsidy cost for the central government, calculated as the difference between the borrowing cost for the central government and the interest rate applicable to the loan concerned.

Accrued interest shall be allocated to the principal amount of the central government's claim.

4.4.2 Borrowings

Total borrowings amount at EUR 1,703,055 million, which represents 78.1% of total liabilities in the central government balance sheet. 99% of total borrowings consist in bonds issued that are negotiable, i.e. that can be traded on capital markets. Other borrowings include financial lease liabilities, liabilities arising from public-to-private partnerships and debts taken over from third parties.

Accounting policies related to borrowings are included in French state accounting standard 11 'Financial debts and derivative financial instruments'.

Financial debts arise from a funding decision by the central government or a decision to assume the debt of a third party. They correspond to:

- the counterpart to funds intended to fund the Central Government, repayable at maturity and giving rise to interest payments;
- the counterpart to the asset that they are intended to finance; or
- the counterpart to a financial expense in the case of debts assumed by the Central Government.

To qualify for recognition in central government's accounts, a financial liability must meet the general recognition criteria for a liability, as well as the following in the case of borrowings:

- the existence of a liability must be certain: the central government must have an obligation to make a payment to a third party, and
- it must be possible to measure the liability reliably.

A financial liability is recognised in the period of issuance of the liability, i.e. when the contract signed and the related funds received, or when the liability is taken over from a third party.

Financial debts are initially measured at nominal repayment value. Subsequent to initial recognition, the carrying amount of financial debts is equal to the amortised cost. The accounting considers the redemption value, which is usually the face value (except in the case of index-linked securities), and any premium and discount. Issues of indexed securities are recognised at the indexed face amount.

The premium or discount is recognised on the date of issue as the difference between the issue price and the face amount or index-linked face amount of government securities. Premiums are recognised as financial revenue and discounts are recognised as a financial expense. Both are allocated over the term of the loan according to the actuarial method. Premiums and discounts are amortised over the life of the securities. The difference between the sale price and the value redeemed at maturity are offset over this period by payments that are different from the interest rate on the date of issue.

Transaction costs, such as loan issuance costs, include expenses and commissions paid to financial intermediaries. They consist mainly of bank commissions charged for setting up the loan or fees paid to outside service providers. These costs are part of the overall cost of financing. They are initially recognised in the balance sheet as prepaid expenses and are allocated to surplus or deficit

over the term of the loan to which they relate on an actuarial basis (or on a straight-line basis if the impact is not material).

Interest on borrowings is recognised as an expense. Where interest is capitalised in financial debt, the balancing entry is recognised in annual interest expense. At each reporting date, interest accrued but not yet due in respect of loans issued, taken out or taken over is recognised in surplus or deficit.

A debt is extinguished when it is redeemed or when the contractual obligation to deliver cash expires. In the latter case, if no consideration is provided in exchange for the expiry of the obligation, revenue is recognised. Unallocated issue premiums relating to the redeemed portion of the loan are taken to surplus or deficit for the period.

Accounting standard 11 does not include any rule relating to the accounting of debt restructurings for the central government.

4.4.3 Implementation or application issues

No transitory period was needed for the accounting of loans and borrowings upon first-time implementation of the French accrual accounting standards.

As per French government representative who responded to our questionnaire, the approach taken in the accounting standards for loans and borrowings is pragmatic to take into account the nature of the transactions carried out by the French State, while inspired by accounting rules for private companies.

She also sees complexity of the subject matter as the main challenge in the accounting for loans and borrowings, which requires development of a strong expertise within the central government.

4.5 Lithuania

4.5.1 Loans

Loans amount at EUR 3,713 million, which is 7.9 % of the total assets of the government of Lithuania at 31 December 2016 (EUR 47,071 million).

All loans are classified under the following three levels and sublevels of categories in the chart of accounts:

- first split between domestic and foreign loans;
- second split between long-term part of long-term loans, current year portion of long-term loans and short-term loans;
- last split between the following subcategories:
 - loans to appropriation managers;
 - loans to municipalities;
 - loans to non-financial corporations;
 - loans to householders;
 - loans for financial institutions;
 - loans to social security funds;

- loans to non-budgetary funds.

Domestic long-term loans to social security funds (EUR 2,939 million) represents the largest category (79.2% of total loans). 43.9% of these loans (EUR 1,290 million) are concessionary loans that bear below market interest rates.

An entity recognises a financial asset in its statement of financial position when, and only when, it becomes a party to the contractual provisions of the instrument. It is when the entity obtains the right to receive cash or other financial asset.

Under Lithuanian public sector accounting standards (LPSAS), which are based on IPSAS, loans are accounted for at amortised cost. Available-for-sale financial assets are measured at fair value.

Nonperforming loans are evaluated as to their recovery and any impairment losses are recognised as expenses. When a loan cannot be recovered any more, it is written-off from the accounting registers.

4.5.2 Borrowings

Total borrowings amount at EUR 15,824 million, which represents 87.7% of total liabilities (EUR 18,042 million) in the financial statements of the central government. The main categories are bonds issued (EUR 13,604 million) and loans from international institutions (EUR 1,720 million). The remaining balance represents treasury notes (EUR 389 million) and loans from banks (EUR 111 million).

All securities are classified under the following three levels and sublevels of categories in the chart of accounts:

- first split between domestic and foreign securities;
- second split between long-term part of long-term securities, current year portion of long-term securities and short-term securities;
- last split between the following subcategories:
 - loans from banks;
 - loans from international institutions;
 - bonds issued;
 - treasury notes;
 - loans from EU programs.

Bonds issued represent by far the largest category of borrowings (86.7%).

An entity recognises a financial liability in its statement of financial position when, and only when, it becomes a party to the contractual provisions of the instrument. It is when the entity is obliged to transfer cash or other financial assets to another party.

Borrowings are measured at amortised cost. According to LPSAS, if the interest rate of the borrowing coincides with the market interest rate, the amortised cost value is equal to the acquisition value.

Transaction costs are recognised as operating or other expenses in the period in which they are incurred.

There are no borrowings issued at below market interest rates. If they were, they would be amortised using the market interest rate.

In respect of debt restructuring, if the conditions of the debt restructuring substantially change the initial terms of the loan agreement (for example, if it significantly extends the terms of repayment), the old borrowing is derecognised and a new debt is registered instead. The agreement to postpone the interest payment is considered as the granting of a new loan (which is equal to the postponed interest payment amount).

4.5.3 Implementation or application issues

According to the Lithuanian government, the main challenge in the accounting for loans and borrowings is the large amount of data that needs to be treated at the end of the year. The difficulty also comes from the heterogeneity of the systems that are used (SAP for loans and borrowings, and FVIS (Navision) for other items).

Highly skilled professionals are needed as the system can not foresee atypical cases.

The Lithuanian government notes the following main benefits in relation to the application of LPSAS to loans and borrowings:

- full disclosure of all transactions;
- time factor is evaluated;
- impairment of assets is evaluated.

4.6 Sweden

4.6.1 Loans

Central government lending amounts at SEK 455.8 billion at 31 December 2016. This is 28.5% of the Swedish central government total assets. Expected losses on loans are SEK 28.6 billion (SEK 26.9 billion on student loans).

Loans to the Swedish National bank (Riksbanken) (SEK 256.5 billion) and student loans (SEK 185.1 billion after impairment) make up most of central government lending. The remaining part consists of loans to state-owned enterprises, Ireland and other loans.

The breakdown is as follows (in SEK billion):

Loans	Loan amount	Expected losses	Carrying amount in the balance sheet
Swedish National Bank	256,5	-	256,5
Student loans	212,0	26,9	185,1
Other loans	15,9	1,7	14,2
Total	484,4	28,6	455,8

Loans are recognised on the disbursement date.

They are measured at amortised cost (using the effective rate method). Concessionary loans and other loans at below market conditions (e.g. student loans) are valued to present value of future payments. The discount rate is the borrowing rate for Swedish state bonds of a similar maturity.

The total carrying amount of loans at below market conditions (nearly exclusively student loans) is SEK 186.5 billion at 31 December 2016.

The gross carrying amount of non-performing loans and the related expected losses are accounted for and disclosed in supplementary notes per loan category. Expected losses should be separated between losses where the borrower is not expected to meet the loans terms and losses where the borrower does not need to repay a “market interest rate” or repay the principal.

4.6.2 Borrowings

Central government debts amount at SEK 1,292 billion at 31 December 2016, or 64.4% of the central government liabilities. Borrowings are split between borrowings in domestic currency (SEK 879 billion) and borrowings in foreign currency (SEK 413 billion).

Borrowings are recognised on the contractual date.

They are measured at amortised cost. Borrowings in foreign currency are recognized at the exchange rate at year end.

Transaction costs are accounted for as follows: set-up fees are recognised when incurred (they finance the agencies initial cost for administration), other fees (e.g. administration fees and delay fees) and interest are recognised in the year to which they relate.

No accounting policy exists for debt restructurings.

4.6.3 Implementation or application issues

As per Swedish government, the main difficulty in respect of accounting for loans and borrowings is to develop a reliable method for estimating the future cash flows for some loans, e.g. students' loans. The methodology takes into account macroeconomic assumptions and has developed over time.

The Swedish law requires to decide how all expected losses on loans should be financed. This enhances accountability as it forces politicians to take responsibility for future budget implications. This is however only possible if the present value of the loans is determined reliably. It is a good example of how good accounting supports accountability and decision making.

4.7 Comparison

The table below provides a high-level comparison of the main accounting principles related to loans and borrowings as applied by the three governments selected for our analysis.

Figure 12: Comparison of the main accounting principles related to loans and borrowings

	France	Lithuania	Sweden
Applicable rules	National rules based on international standards (standards 7 and 11).	LPSAS (Lithuanian Public Sector Accounting Standards) based on IPSAS.	National rules for the private sector (based on IFRS and IPSAS).
Main categories of loans and borrowings	Loans: loans to foreign governments (e.g. Greek loan). Borrowings: bonds issued.	Loans: domestic loans to social security funds. Borrowings: bonds issued and loans from international institutions.	Loans: loans to the Swedish National Bank and student loans. Borrowings: bonds issued.
Measurement	Loans: initially at nominal value and subsequently at their present value. Borrowings: initially at nominal repayment value and subsequently at amortised cost.	Loans: amortised cost. Available-for-sale financial assets at fair value. Borrowings: amortised cost.	Loans: amortised cost. Students' loans at their present value. Borrowings: amortised cost.

5 Difficulties/issues when accounting for loans and borrowings

Based on the input gathered from Member States at the time of the 2014 PwC study, on the country analysis presented under chapter 4 and the additional analyses performed in the context of this issue paper, we see the following as the main difficulties/issues that arise when accounting for loans and borrowings:

- Complexity of the subject matter and inherently difficult measurement.
- Comparability in presentation and disclosures.

5.1 Complexity of the subject matter and inherently difficult measurement

Accounting for loans and borrowings under the revised IPSAS 41 'Financial instruments' is a technically complex area.

Specialised expertise is needed to determine how debt instruments should be classified and measured at the start of the contract (measurement at amortised cost, at fair value through equity or fair value through profit or loss) and how to properly apply the concepts of amortised cost and fair value.

Tailored (and sometimes complex) models should be developed to capture the risks inherent to the recoverability of the loans and determine any impairment under the new expected credit loss model in IPSAS 41 or to assess fair value for debt instruments measured at fair value. Previous impairment models under international accounting standards used to assess credit losses incurred to date; the new models will need to include a forward-looking dimension based on well-defined rules. Fair value measurement should take into account where applicable the characteristics of the public sector, e.g. by considering those specific cases where market comparables are lacking.

Management judgment should be exercised to estimate the future cash flows, taking into account uncertainties about the probability of occurrence and timing of these cash flows, and other measurement assumptions.

Accounting complexity also exists around de-recognition rules of financial assets and financial liabilities. Professional judgment needs to be applied to determine whether de-recognition criteria are met or not.

5.2 Comparability in presentation and disclosures

Governments usually enter into large amounts of borrowings to fund their investments and operating activities. Government debts therefore often represent the biggest caption in a government's balance sheet.

On the assets' side, certain types of loans may represent large amounts too and/or include certain risks as to their recoverability in case the debtor of the loans default.

IPSAS rules contain detailed rules regarding presentation and disclosure of financial instruments, including loans and borrowings. The objective is to enable users to evaluate: (a) the significance of financial instruments for the entity's financial position and performance and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

Judgment may be needed in assessing the categories of loans and borrowings to present on the balance sheet and the more detailed split to provide in the notes to the accounts on the one hand and the nature and extent of the disclosures on the other hand.

The question arises as to whether some of the presentation and disclosure requirements should be further tailored to the European context.

6 Discussion of matters relevant for a European harmonisation

In our opinion, the main topics that are worth being discussed at a European level in the context of the EPSAS standard setting, that are relevant for a European harmonisation and may help enhance comparability of the reporting between EU Member States, relate to:

- The complexity of the subject matter and the inherent difficulties arising when accounting for loans and borrowings, in particular in respect of their measurement.
- The need for a comparable presentation of loans and borrowings and the appropriateness of the related disclosures.

6.1 Complexity of the subject matter and inherently difficult measurement

IPSAS already provide detailed rules in relation to the recognition, measurement, presentation and disclosure of loans and borrowings, including in relation to certain types of transactions that are specific to the public sector, such as concessionary loans. The subject matter is however complex and leveraging on best practices with regard to the accounting of loans and borrowings and related disclosures may further facilitate good accounting and reporting by Member States.

Member States may wish to discuss the opportunity to develop specific EPSAS guidance for the measurement of certain categories of loans, including the application of the new forward-looking impairment model to facilitate implementation and ensure a greater level of consistency in application. This might in particular be helpful for governments that make the move to EPSAS from a cash-based environment and may not have developed a relevant expertise in this area.

Topics for discussion might include:

- *Methodology used to estimate expected credit loss on certain types of loans.*

The level of sophistication in the analytical models used to estimate the expected loss on loans should inevitably vary, given the differing nature of the loans, country specific situation, economic characteristics of the beneficiaries (e.g. sector to which they belong) and financial risks associated with them.

Developing guidance and sharing best practices with regard to the use of models for determining expected credit losses following the impairment model for certain types of loans under IPSAS may help achieve the objectives of harmonisation at EU level.

In order to make this possible, the usefulness of performing a survey of the major types of loans granted by EU Member States could be discussed. Best practices might then be identified and shared with the Member States. Based on the outcome of the survey, measurement guidance might also be developed where appropriate.

- *Methodology used to determine the fair value of certain debt instruments.*

Depending on the contractual cash flows characteristics of the debt instruments under review and the business model of the government, fair value measurement may be required under IPSAS. The fair value of loans and borrowings should also be disclosed.

Providing additional guidance to/sharing best practices with Member States on how fair value is determined may lead to better harmonisation and transparency for the readers of the accounts.

6.2 Comparability in presentation and disclosure

The need for some level of consistency in the presentation of loans and borrowings may be discussed in order to enhance comparability of the reporting between EU Member States.

The discussion may include whether loans and borrowings should be presented on a separate line item on the statement of financial position. Under international accounting standards (such as IPSAS and IFRS), further subclassification is generally given in the notes by class in a way that is appropriate to the circumstances of the reporting public sector entity.

Various subclassifications may be used, for example based on those types of loans and borrowings that are most frequently encountered in practice. The classification used in the ESA 2010 reporting might also be discussed. Examples of groups for loans and borrowings may be found in accounting practices followed by Member States selected for the benchmarking analysis in chapter 4.

7 PwC's recommendations on the way forward

We present below our recommendations in the same order as the topics proposed for discussion for a European harmonisation under Chapter 6.

7.1 Complexity of the subject matter and inherently difficult measurement

Borrowings often represent very large amounts of financial liabilities in government balance sheets. Loans can sometimes be significant too; when they are granted to certain (categories of) economic operators, they may involve high risks for Member States.

Loans and borrowings are material for governments and should be reflected in financial statements in a transparent way. Financial statements should properly depict the substance of the (sometimes complex) arrangements, the financial risks that are taken by governments when they enter into significant and risky transactions, including in relation to certain types of loans. Similarly, when a government has incurred major (long-term) obligations in relation to its activities, these should be properly reflected in the financial statements too, and appropriate disclosures should be given.

Some fundamental aspects such as the methodology to calculate amortised cost should in our view not give rise to a conceptual debate. Calculation of amortised cost is a well-established practice in the private sector and about half of the central governments declare to already apply it as per PwC study of 2014.

Similarly, measuring large amounts of loans and borrowings in the balance sheet by taking into account the time value of money as required under IPSAS best reflects the economic substance of the transactions (as opposed to measurement at nominal value).

Given the materiality of the amounts and the complexity of the topics involved, we believe that developing EPSAS guidance on some other selected topics (suggestions are presented in 6.1) may be useful to help governments apply the new requirements. It would in addition help enhancing consistency in the measurement of loans.

In addition, when similar types of loans are granted by Member States, sometimes for significant amounts (e.g. when bilateral loans are granted by several Member States to specific Member States in financial distress as part of an overall plan to boost financial stability within the EU), specific guidance may be developed. This should enhance consistency in the evaluation of those loans (e.g. concerning the expected credit losses on those loans) by Member States.

Accounting for financial instruments is a technical area. Simple loans and borrowings can be accounted for by regular accounting staff, but more complex transactions and financial arrangements require specialised expertise. Best practice consists in developing such expertise at the central level in the hands of a limited number of staff, therefore limiting the total cost.

Best practice can also be taken from the private sector. For example, the expected credit loss model required by the new IPSAS 41 standard is taken from IFRS 9 which is applicable to private companies from 2018. The methodology developed by private banks and corporates for evaluating expected credit losses on their loans may constitute an interesting source of inspiration, adapted as appropriate for the characteristics of the loans granted by Member States governments.

7.2 Comparability in presentation and disclosures

In order to achieve comparability in the presentation and disclosure of loans and borrowings across EU governments, we recommend to define a subclassification for loans and borrowings which reflects the major types of transactions that governments have. Such proposed subclassification may provide useful guidance but Member States should however be allowed to adapt it to best suit their particular situation.

When certain specific types of transactions are entered into which trigger a high visibility in the public (e.g., same example as above, when bilateral loans are granted by several Member States to specific Member States as part of an overall plan to boost financial stability within the EU), specific guidance as to the disclosures to be given may also be useful in order to enhance transparency and comparability. It is in our view indeed crucial to consider both materiality and relevance of the information to be provided, i.e. information should be provided if it is important for a proper understanding of the government's assets, liabilities and related risks.